



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE ENROLLED BILL ANALYSIS

Date Amended:	<b>Enrolled</b>	Bill No:	<b>AB 168</b>
Tax:	<b>Sales and Use</b>	Author:	<b>Ridley-Thomas</b>
Related Bills:			

### BILL SUMMARY

This bill would:

- Require the Board of Equalization (Board) and the Franchise Tax Board (FTB) to each provide to the Legislature, the Department of Finance (DOF) and the Legislative Analyst Office (LAO), a report, based on a static revenue analysis, of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, that produced a revenue loss in excess of \$25 million in the prior fiscal year.
- Require the DOF to provide, biennially, to the Legislature and the LAO, a report, based on a dynamic revenue analysis, of the estimated revenue losses attributable to tax expenditures that produced revenue losses in excess of \$25 million for each of the two most recent fiscal years, as specified. The report would include a comparison of the reports submitted by the Board and FTB.
- Require the LAO to review the reports and make recommendations to the Legislature as to which tax expenditures should be modified or repealed.

### ANALYSIS

#### Current Law

Since 1971, pursuant to Section 13305 of the Government Code, the Department of Finance has been required to provide a tax expenditure report to the Legislature. Chapter 1762, Statutes of 1971, required that the report be submitted to the Legislature once every two years. Chapter 268, Statutes of 1984, increased the reporting frequency to once a year. The required report includes each of the following:

- A comprehensive list of tax expenditures.
- Additional detail on individual categories of tax expenditures.
- Historical information on the enactment and repeal of tax expenditures.

#### Proposed Law

This bill would add Article 2.2 (commencing with Section 13310) to Chapter 3 of Part 1 of Division 2 of Title 2 of, and to repeal Section 13305 of, the Government Code to, among other things, do the following:

- 1) On or before November 15, 2006, and on before each November 15 thereafter, require the Board and the FTB to each provide reports to the Legislature, DOF, and the LAO, based upon a static revenue analysis of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, that produced a revenue loss in excess of \$25 million for the prior fiscal year.

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*This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position*

- 2) On or before February 1, 2007, and on or before each January 15<sup>th</sup> each odd-numbered year thereafter, require the DOF to submit a tax expenditure report to the Legislature and the LAO, based upon a dynamic revenue analysis of the estimated revenue losses attributable to tax expenditures for each of the two most recent fiscal years. If resources are not available to make the report based upon a dynamic revenue analysis, then the DOF can provide the report based upon a static revenue analysis. The report would also contain:
- a) a comparison of the reports prepared by the DOF, based on the dynamic revenue analysis, and the reports submitted by the Board and the FTB.
  - b) information on the number of returns or taxpayers affected, and the distribution of each tax expenditure based on information provided by the FTB, or by the Board in the case of sales and use tax expenditures that are separately identified on returns or claims, to the extent feasible. For business tax expenditures, the report shall contain information by size of the business or industry, by size of total receipts, and by type of business or industry; for personal income tax expenditures, information on adjusted gross income brackets, as provided by the FTB.
  - c) tax expenditures for which the following applies: (1) produced revenue losses in excess of \$25 million, as reported by the Board and the FTB; and (2) include two to 10 tax expenditures. The tax expenditures to be included shall be selected in a manner that ensures that all of the tax expenditures listed in the report prepared by the Board and the FTB be included in a report at least once every eight years.
- 3) Require the LAO, on or before March 1, 2007, and on or before every March 1 thereafter, to review the tax expenditure reports provided by the Board, FTB, and DOF and make recommendations to the Legislature regarding which tax expenditures should be modified or repealed.

This bill would define “tax expenditure” as a credit, deduction, exclusion, exemption, or any other tax benefit as provided for by state law.

This bill would define “static revenue analysis” as the historical method used by the Board and FTB for evaluating tax expenditures that takes into account only the most direct economic responses to tax expenditures.

This bill would define “dynamic revenue analysis” as the historical method used by DOF for evaluating tax expenditures based on assumptions that estimate the probable behavioral responses of taxpayers, businesses, and other citizens to those tax expenditures, and that includes a statement identifying those assumptions.

### **Background**

This bill is identical to Assembly Bill 2106 (Ridley-Thomas) of the 2004 session. AB 2106 was developed as a result of Assembly Budget Committee Oversight hearings at which was discussed the usefulness of regular ongoing review and evaluation of tax expenditures as a means to eliminate wasteful or ineffective programs. Board staff participated in the oversight hearings and had no concerns in complying with the provisions of the bill.

AB 2106 was vetoed by Governor Schwarzenegger. The Governor's veto message states:

"Under existing law, the Department of Finance already is required to provide an annual tax expenditure report to the Legislature containing specific information. This bill changes the type of information that is provided in the annual report. However, some of the information that Department of Finance would be required to report is not available. For example, the original intent of a given tax expenditure is often not clearly defined in the enabling statute. In addition, the number and income distribution of taxpayers benefiting from sales tax exemptions would not be known because this information is not required to be reported by retailers when filing their tax returns. Furthermore, some of the information might not be available for reporting to the Legislature because of existing confidentiality requirements."

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the state Treasurer, Phil Angelides, and backed by Lenny Goldberg of the California Tax Reform Association to provide for a systematic review of tax expenditures in order to determine their effectiveness.
2. **Key amendments.** The **August 30, 2005** amendments provided that: (1) the report submitted by the DOF, biennially, is based on the two most recent fiscal years, as specified; and (2) the DOF may provide the report based on a static revenue analysis, if resources are not available to provide the report based on a dynamic revenue analysis. The **June 27, 2005 amendments** provided that: (1) the tax expenditure report prepared by the Board and FTB include those tax expenditures with a revenue loss in excess of \$25 million; (2) the report provided by the DOF include those tax expenditures that produced revenue losses in excess of \$25 million; (3) include two to 10 tax expenditures, as specified; and (4) be due each odd-numbered year. The **May 26, 2005 amendments** did the following: (1) provide that the DOF include information in the tax expenditures report, based on information provided by the Board and FTB, regarding the number of tax returns or taxpayers affected by the tax expenditure and the distribution of business tax expenditures by size of business or industry, by size of total receipts, and by type of business or industry; (2) provide that the report provided by the DOF would include those tax expenditures designated by the Senate and Assembly Committees on Revenue and Taxation, as specified; and (3) add co-authors. The **March 10, 2005 amendments** did the following: (1) required the Board and the FTB to provide reports on tax expenditures based upon a static revenue analysis, as defined, for the prior fiscal year; (2) revised the tax expenditure report provided by the DOF. The report would be based on a dynamic revenue analysis and include a comparison of the reports submitted by the Board and the FTB; and (3) required the LAO to review the tax expenditure reports provided by the Board, FTB, and DOF and make recommendations to the Legislature regarding which tax expenditures should be modified or repealed.

3. **The Board does not have specific data on tax expenditures.** In general, revenue estimates and expenditure data for the Personal Income Tax and Corporation Tax Laws are easier to quantify than they are for the Sales and Use Tax Law. Personal income and corporation tax returns contain significant detail regarding different sources of income and types of exemptions, exclusions, deductions, and credits claimed. Thus, tax return data are often available when estimating the fiscal impact of various income and corporate tax expenditure programs. In contrast, returns filed by taxpayers under the Sales and Use Tax Law (a copy of which is attached) contain little specific information regarding tax expenditures).

As shown on the attached sales and use tax return, some of the more common tax expenditures allowed under the Sales and Use Tax Law are separately identified on the return itself for purposes of allowing taxpayers to claim the deduction. These include deductions for, among others, sales of food products, sales to the U.S. Government, sales in interstate or foreign commerce, and nontaxable labor (note, the law contains numerous other tax exemptions and exclusions not separately identified on the return). However, instead of actually itemizing these deductions, many taxpayers simply report their taxable sales, netting out any exempt sales. Any attempt to capture the amount of exempt transactions would require a much more extensive tax return and would require a very large effort from taxpayers to detail these transactions. However, even if the Board were to require retailers to report on each tax expenditure, we would still not have any data regarding the consumers that are actually benefiting from these exemptions.

Consequently, return information does not capture specific data on the myriad of tax exemptions and exclusions provided under the law, and is not a reliable source to use in making estimates of revenue losses attributable to those exemptions and exclusions. As such, the Board generally relies on independent data sources when estimating the revenue impacts of various sales tax expenditure programs.

The exception to this is for partial exemptions. The Board currently requires the taxpayer to specify the amount of those exemptions that apply to only a portion of the combined state and local sales and use tax. There are currently five such exemptions in effect:

- Teleproduction Equipment
- Farm Equipment
- Diesel Fuel Used in Farming and Food Processing
- Timber Harvesting Equipment and Machinery
- Racehorse Breeding Stock

Sales of these commodities are exempt from the *state* sales and use tax. Local and special district sales and use taxes continue to apply. In order for a taxpayer to claim these exemptions, they must report the amount of the transactions that are subject to the partial exemption.

Consequently, since the bill specifies that the Board would prepare a report of the estimated revenue losses attributable to each tax expenditure, to the extent feasible, during the prior fiscal year with a revenue loss in excess of \$25 million, it is assumed that the Board would provide information that it is currently capturing, and for all other tax expenditures, the Board would estimate the revenue losses using independent data sources.

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4. **Board does not have certain information on tax expenditures available to businesses.** This bill requires the DOF to include information in their report, based on information provided by the Board in the case of sales and use tax expenditures that are separately identified on returns or claims, to the extent feasible: (1) the number of tax returns or taxpayers affected by the tax expenditure; and (2) the distribution of each tax expenditure by size of the business or industry, by size of total receipts, and by type of business or industry. As previously stated, taxpayers sales of exempt sales are for the most part not reported separately to the Board. However, even if the Board were to require retailers to report on each tax expenditure, the Board would still not have data on the size of the business or industry affected by the tax expenditure or the amount of total receipts.
5. **The Board's Publication 61, Sales and Use Taxes: Exemptions and Exclusions, provides a detailed listing of various exemptions and exclusions from the sales and use tax.** Publication 61 summarizes the various sales and use tax exemptions and exclusions. The publication has two sections: first by category and second by alphabetical reference. The listings provide a brief general description of the exemption or exclusion, including the statutory authority. The listing by category also provides an estimate of the revenue loss of the exemption or exclusion, if available. As previously stated (see Comment 3), a revenue loss of a particular tax expenditure is not always possible to quantify.
6. **Special Taxes - the Board does not have specific data on all tax expenditures.** The Board administers the following special tax and fee programs: Aircraft Jet Fuel Tax, Alcoholic Beverage Tax, California Tire Fee, Childhood Lead Poisoning Prevention Fee, Cigarette and Tobacco Products Tax, Diesel Fuel Tax, Electronic Waste Recycling Fee, Emergency Telephone Users Surcharge, Energy Resources Surcharge, Hazardous Substances Tax, Insurance Tax, Integrated Waste Management Fee, Interstate User Tax, Marine Invasive Species Fee, Motor Vehicle Fuel Tax, Natural Gas Surcharge, Occupational Lead Poisoning Prevention Fee, Oil Spill Response, Prevention, and Administration Fees, Underground Storage Tank Maintenance Fee, Use Fuel Tax and Water Rights Fee.

Some of the major tax exemptions are: Distilled spirits exported or sold to common carriers, Distilled spirits sold to armed forces, Beer and wine exported from California, Exempt distributions of cigarettes sold and shipped in interstate or foreign commerce, Exempt distributions of cigarettes sold to interstate foreign passenger common carriers, Exempt distributions of cigarettes sold to U.S. Military exchanges, commissaries, ship stores & U.S. Veterans Administration, Motor vehicle and diesel fuel exported, Fuel sold to the United States Government, Diesel and use fuel for use on farms, Diesel and use fuel for exempt bus operators, Diesel and use fuel for off-highway vehicle operations, Aircraft jet fuel sold to the United States Armed Forces, Aircraft jet fuel sold to air common carriers, and Aircraft jet fuel exported.

As shown above, some of the more common special tax expenditures are separately identified on the return. However, like sales and use tax expenditures, many taxpayers net out exempt sales or combine exempt sales on one line of the return. For these reasons, the return does not capture all data on the various exemptions. Consequently, the Board generally relies on independent data sources when estimating the revenue impacts of various special tax expenditure programs.



**7. Property Taxes. Property taxes are largely administered by county assessors in the state's 58 counties. The Board provides oversight to the 58 county assessors and monitors the adequacy of their assessment practices.**

The state Constitution provides for a variety of full and partial exemptions from the property tax. Some of the exemptions are required by the Constitution. Others are not specifically required but the Constitution provides that the Legislature may, by statute, provide for the exemption. This bill defines "tax expenditures" to mean any special provision in the tax law that results in the collection of fewer tax revenues than would be collected under the basic tax structure. Would the exemptions required by the state Constitution be considered "tax expenditures" under the provisions of this bill<sup>1</sup>?

There are over 100 exemptions and exclusions from property tax. "Exemption" is the freedom from a general duty or service, or immunity from certain legal obligations such as the payment of taxes. An exclusion, for property tax purposes, is the denial of reassessment. For real property, some of the major exemptions are: Disabled Veterans Exemption, Homeowners' Exemption<sup>2</sup>, and Welfare Exemption. For real property, some of the major exclusions are: Disabled New Construction Exclusion, Disaster Relief Change in Ownership and New Construction Exclusions, Interspousal Change in Ownership Exclusion, Over 55 and Disabled Homeowners' Change in Ownership Exclusion, Parent-Child and Grandparent-Grandchild Change in Ownership Exclusion, and Seismic Safety New Construction Exclusion.

Data on some of the exemptions are maintained by the county assessors. For the exclusions, in general, the data is not maintained. In the case where data is not maintained, the Board would estimate the revenue impact using independent data sources, to the extent feasible. However, in some cases, it is not possible to quantify the revenue loss of a tax expenditure because the data is not available.

In addition, there are preferential tax treatments for real property. Would preferential tax treatments be considered tax expenditures? One of the major preferential tax treatments is the Williamson Act. The Williamson Act program provides a tax incentive for the conservation of farmlands, open space, and wildlife habitat lands by reducing the property tax on land that is restricted for these purposes. For real property qualifying for special treatment under the Williamson Act<sup>3</sup>, data is available to develop an estimated revenue loss.

For personal property, some of the major exemptions are: Aircraft Being Repaired, Aircraft of Historical Significance, Business Inventories<sup>4</sup>, Cargo Containers Used in Ocean Commerce, Financial Assets, Household Furnishings and Personal Effects, Vessels, Documented Vessels, and Vessels Under Construction. For the personal property tax exemptions, data is maintained on some of the exemptions. For those exemptions where data is not maintained, a revenue estimate would be developed

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<sup>1</sup> One of the largest tax expenditures is the Proposition 13 revenue loss, and the Proposition 8 decline in value.

<sup>2</sup> The Homeowners' Exemption is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief of the Budget Act.

<sup>3</sup> The Williamson Act is a budget expenditure. The counties are reimbursed by the state. It is shown in Schedule 9 under Tax Relief in the Budget Act.

<sup>4</sup> Business Inventories are 100 percent exempt starting 1980-81. This exemption is often overlooked because the owner does not have to file a claim.

using independent data sources, to the extent feasible, unless such data was not available. An example of a personal property tax expenditure for which a revenue loss could not be quantified would be Financial Assets.

### **COST ESTIMATE**

As explained previously, the Board does not capture reliable data on tax expenditures from tax returns or from taxpayers, other than that obtained on the five partial tax exemptions. The bill states that the Board would provide a report, based on a static revenue analysis, of each tax expenditure with a revenue loss in excess of \$25 million during the prior fiscal year. It is assumed that the Board's report would contain information that we currently obtain from returns, and for all other tax expenditures, the Board would estimate the revenue losses using independent sources. Based on that assumption, any costs associated with this bill would be minor (i.e., under \$50,000).

### **REVENUE ESTIMATE**

To the extent that future reviews and evaluations result in the identification and termination of ineffective or inappropriate tax expenditures, enactment of this measure could result in unknown additional revenues.

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